FRANCHISE CONTRACTS, OPPORTUNISM AND THE QUALITY OF LAW

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Abstract

In this paper, I examine long-term franchise contracts in relation to franchise-termination laws. I conclude that, given the scope for opportunistic behavior in franchise relationships, we might expect to see both legal and extra-legal structures governing the termination of franchise contracts. This conclusion follows from the observation that there are no legal or extra-legal mechanisms credibly able to enforce all promises, particularly promises concerning the franchisor's restraint over appropriating sold franchises, the value of the franchise brand name and the franchisee's good faith effort, leaving the franchise contract seriously incomplete. If both parties could guarantee all promises, opportunistic behavior would disappear, in addition to the possibility of adverse selection occurring and reducing the number of franchise contracts. Adverse selection occurs when, not knowing the true value of promises, trading partners substitute an average quality signal. Above-average quality contractors then leave the market, as it will not reward them sufficiently. Therefore, the quality of legal and extra-legal enforcement mechanisms is central to the nature of franchise contractual arrangements. Typically, these arrangements eschew complexity, which indicates the avoidance of introducing further scope for argument and uncertainty over the value of promises.

Key words: contracts, hostages, franchising. Email: a.dnes@hull.ac.uk

I. INTRODUCTION

This paper contributes to the understanding of long-term franchise contracts by examining three key features. First, contracts are frequently restricted in law such that the franchisor's ability to terminate the franchise contract is curtailed, possibly by a requirement for good cause. Second, the governance of franchise contracts tends toward simplicity, with evident limitations on the range of contracting devices that courts tolerate. Third, extra-juridical management mechanisms, including those focused on arbitration, monitoring and enforcement, are important in franchising.[1] An explanation for these features may be found using information economics. Broadly interpreted, franchise contracts avoid unrestricted termination rights, tend toward simplicity, and use well-defined extra-legal management mechanisms owing to the scope for opportunism identified in the economics literature and often referred to as a two-way moral-hazard problem.[2] In the sections below, I first examine the implications of opportunism for franchise contracts before linking these to information considerations and governance mechanisms. I draw on observations of business practices and cases in law throughout the paper.

II. CONTRACTS, OPPORTUNISM AND THE PROBABILITY OF HOLD-UP IN FRANCHISE CONTRACTS

In the terms used by Williamson[3] in his transaction-cost analysis of firm asset specificity, bounded rationality, opportunism, and uncertainty all affect long-term franchise contracts making ex-post 'hold-up' attractive to a party. Opportunism may arise over specific investments or over the enforcement of effort levels in a contract. Williamson emphasizes asset specificity as the major driving force tempting opportunistic behavior in contracting problems. Individuals may make highly specific investments, committing them to a long-term contract. Not only is enforcement costly, however, there are major difficulties in specifying all of the contingencies present as well.

In economic terms, specific investments result in appropriable quasi rents (pure economic surpluses going beyond a normal-profit return on investment), the difference between ex-ante expected returns to the investor and the amount that must be left in the contract ex-post to deter the

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[1] S. MACAULAY, LAW AND THE BALANCE OF POWER: THE AUTOMOBILE MANUFACTURERS AND THEIR DEALERS (Russell Sage Foundation 1966); Antony W. Dnes, *A Case-Study Analysis of Franchise Contracts*, 22 J. LEGAL STUD. 367 (1993); Antony W. Dnes, *Hostages, Marginal Deterrence and Franchise Contracts*, 9 J. CORP. FIN. 317 (2003); Christopher R. Drahozal & Keith N. Hylton, *The Economics of Litigation and Arbitration: An Application to Franchise Contracts*, 32 J. LEGAL STUD. 549 (2003).

[2] *See* Francine Lafontaine, *Agency Theory and Franchising: Some Empirical Results*, 23 RAND J. ECON. 263 (1992); Francine Lafontaine & Kathryn L. Shaw, *The Dynamics of Franchise Contracts: Evidence From Panel Data*, 107 J. POL. ECON. 1041 (1999); James A. Brickley, *Royalty Rates and Upfront Fees in Share Contracts: Evidence From Franchising* 18 J.L. ECON. & ORG. 511 (2002) (who finds that franchisors' profits are improved by laws governing franchise termination, and that franchisees may also be better off owing to the reduced threat of termination).

[3] Oliver E. Williamson, *Credible Commitments: Using Hostages to Support Exchange*, 73 AM. ECON. REV. 519 (1983); OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 31 (Free Press 1985).

investor from abandoning the contract.[4] Such investments therefore need support, either through law, or, if the quality of law is insufficient, through private enforcement mechanisms. Private enforcement is normally considered to require 'hands-tying' through the posting of a 'hostage,' the creation of offsetting vulnerability affecting the party who would otherwise be tempted to practice hold-up and appropriate quasi-rents. If it is not possible to rely on court enforcement of the original terms, or if it is desirable to avoid court costs, or even to avoid alternative dispute resolution, the hostage may be a cost-efficient enforcement mechanism. It works by ensuring that the promisor has more to lose by cheating than by sticking with the original terms: it deters opportunistic re-negotiation. The penalty from cheating needs to be at least as large as the benefit from cheating.

Careless choice of the hostage may set up an incentive for a trading partner to appropriate it, which would be self-defeating. Implicit hostages are less vulnerable to opportunistic appropriation by trading partners compared with pecuniary hostages. The person holding the hostage should not find it to be directly of value. A hostage needs to be an 'ugly princess' in the terms of transactions-cost analysis.

Benjamin Klein[5] has developed work on asset specificity and hold-up problems into a distinct analysis of 'probabilistic hold-up.' The analysis is distinct because he regards private enforcement mechanisms as a means to stabilize contracts within a foreseeable range of variation of market conditions. Outside of the range, renegotiation, or breakdown of the relationship, may be anticipated, and, then, enforcement of the original contract where it was never intended to apply could be opportunistic. Firms use private enforcement alongside court enforcement and renegotiate contracts periodically,[6] as it is too costly to specify all contingencies in a

[4] The *quasi* rent is the difference between ex-post returns on the total investment and normal returns on the avoidable investment, and the appropriable part is governed by the next-highest valuing user of the total investment. In their article, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process,* 21 J.L. & ECON. 297 (1978), Alchain, Crawford & Klein give an example of a manufacturer investing in a plant with a specific use and earning a normal return by selling output to a single buyer for a net revenue (after meeting avoidable costs) of $x. There may be no scrap value for the plant, implying that the entire net revenue is a quasi rent once the investment is made. However, if there is an alternative buyer of the output who values it (net) at $(x-k), the appropriable part of the quasi rent is only $k - i.e. the original buyer can attempt to drop the price by $k, after the manufacturer has made the investment, before the manufacturer will switch to the alternative buyer. I give a simple numerical example of hold up in ANTONY DNES, ECONOMICS OF LAW: PROPERTY, CONTRACTS AND OBLIGATIONS 82 (2005).

[5] Benjamin Klein, *Why Hold-Ups Occur: The Self Enforcing Range of Contractual Relations,* 34 ECON. INQUIRY, 444, 456 (1996); Benjamin Klein, *Transactions Cost Determinants of "Unfair" Contractual Arrangements,* 70 AM. ECON. REV. 356 (1996).

[6] However, contract modifications are not enforceable without fresh consideration.

contract and equally too expensive to figure out all the problems that may need to be held in check by hostages.

For any hostage to be effective it must set the expected gain from cheating equal to zero. This implies that hostages will be worth much more than the actual gain when monitoring costs are positive: in terms of the economics of law, the hostage may represent *punitive* damages. If there is only a ten percent chance of poor standards being detected then ten times the gain must be taken to render expected gain equal to zero: the contract will always seem 'unfair' in this sense of obeying the general principle of criminal deterrence.[7] One question therefore concerns the extent to which franchise termination laws, which usually constrain the franchisor's prerogative to terminate the franchise contract, may interfere with good governance by allowing poor franchisees to continue working in a chain. Conversely, we may worry that an absence of such laws would permit the franchisor to appropriate local franchise territories by opportunistically contriving excuses to do so once a franchisee had a local business up and running.

III. FRANCHISE CONTRACTS

The scope for opportunism in franchise contracts can take several forms.[8] Chiseling by the franchisee on performance quality could take the form of lower effort levels over things like cleanliness of the store, or the quality of the product or service. A below-standard franchisee might still receive profitable business if non-repeat buyers are attracted by the reputation created for the brand name by the franchisor or other outlets. The franchisor can practice post-contract opportunism over support levels for franchisees—perhaps failing to provide sufficient centralized advertising or neglecting the monitoring of quality standards throughout the network. The franchisor can also attempt opportunistic repossession of franchise territories by claiming problems with franchisee performance, hoping to sell a franchise again or possibly to run a company store.

Most commentators conclude that cheating by the franchisor is controlled by a likely consequential increase in operating costs. In particular, if a franchisor had a reputation for appropriating franchises opportunistically, it would become difficult to recruit new franchisees. There are operating and monitoring cost advantages to franchising that give value to the franchisor's maintaining a reputation for fair dealing. Although

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[7] Criminal law is the correct comparison as the economic analysis of tort law typically assumes the probability of detection to equal one.

[8] This section is based on observations in Paul H. Rubin, *The Theory of the Firm and the Structure of the Franchise Contract,* 21 J.L. & ECON. 223 (1978) at 227; G. Frank Mathewson & Ralph A. Winter, *The Economics of Franchise Contracts,* 28 J.L. & ECON. 503 (1985) at 515; Antony W. Dnes, *Franchise Contracts, in* ENCYCLOPEDIA OF LAW AND ECONOMICS 1092, 1099 (B. Bouckaert & G. De Geest eds., 2000).

franchisors must monitor network standards, they need not monitor day-to-day operations at the satellite stores. Moreover, the present value of this cost advantage over the life of the contract acts as a hostage. As far as the franchisee is concerned, as long as the value of lost entitlement to the franchise profit stream—the share of rents, is greater than the franchisee's expected gain from cheating—a comparable hostage can reinforce franchisee performance in good faith. Franchisors cannot insist on arbitrarily high hostages, which would certainly deter chiseling—arbitrarily high hostages could prove too tempting for franchisors, and franchisees would never agree to them.

Franchise contracts typically require franchisees to pay lump-sum fees to franchisors and to make highly specific investments in equipment. The franchisor usually has the right to terminate the contract if the franchisee is not maintaining quality standards. It is a common observation that these contracts appear to favor the franchisor's interests and an obvious question is why franchisees freely agree to such arrangements.

Of particular interest is Klein's argument that the franchisor's contractual right to terminate the contract supports private enforcement through the common requirement that franchisees lease their properties from the franchisor.[9] The franchisee could be forced to move premises and sacrifice valuable leasehold improvements, which would revert to the franchisor as lessor. This gives the franchisor a hostage with which to control franchisee behavior and enables monitoring to be reduced with an associated cost saving. As I have previously observed, "[t]he franchisor can require the franchisee to move and thereby impose a capital loss on him up to the amount of his initial non-salvageable investment. Hence, a form of collateral to deter cheating is created."[10] Furthermore, in my work surveying franchising practices, I noted that many franchisors avoid the unconstrained use of lease-control as too much like putting a gun to the franchisee's head.[11]

More recently, Klein[12] has moved to the view that the rents attached to the non-salvageable investment should be the focus in valuing the franchisee's potential loss in cases where there are no legal constraints on the franchisor's behavior. His reasoning is based on the claim that sunk costs, or detrimental reliance in legal terms, cannot influence behavior, as truly bygone expenditure is not relevant to future decisions whereas the prospect of losing some of the rents is a current incentive. The argument

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[9] Benjamin Klein, *Transactions Cost Determinants of "Unfair" Contractual Arrangements,* 70 AM. ECON. REV. 356, 358 (1980).
[10] *Id.* at 359.
[11] Antony W. Dnes, *A Case-Study Analysis of Franchise Contracts,* 22 J. LEGAL STUD. 367, 371 (1993).
[12] *See, e.g.,* Benjamin Klein, *The Economics of Franchise Contracts,* 2 J. CORP. FIN. 9 (1995); Benjamin Klein, *Why Hold-Ups Occur: The Self-Enforcing Range of Contractual Relations,* 34 ECON. INQUIRY 444 (1996).

overlooks the influence of law in rendering expenditures recoverable or not, but is most forcefully put in the following passage:

> if the franchisor had made the specific investments . . . but the franchisee was earning the return . . . the incentive on the franchisee . . . would be the same, i.e. the fear of loss of the future return from these specific assets upon termination. Whether the franchisee makes the investment is irrelevant. While it may be easy to think of the loss to the franchisee of these . . . assets . . . it is always the loss of the present discounted value of the future premium (which may include a future expected return on specific assets) compared to the short-run extra return from not performing that determines whether the franchisee performs.[13]

Klein urges us to think of hostages in terms of the loss of specific assets but does not give a precise definition of the "future premium" or "future return". I consider a precise definition below, which *broadly* supports Klein's view but does not support the argument that *ownership* of sunk investment is irrelevant. The law can make a difference to what is, or is not, sunk.

IV. HOSTAGES IN RELATION TO COURT GOVERNANCE

Hostages are used for private enforcement as an alternative to other forms of governance and are influenced by the nature of those alternatives. Legal constraints may influence the *behavior* of the franchisor. Klein notes that franchisors might avoid charging initial fees because courts are motivated by the unconscionability doctrine[14] and might prevent franchisors from terminating contracts at will in cases where franchisees had invested heavily in contract-specific assets.[15] Removal of the franchisor's prerogative over termination at will at the very least dilutes a hostage, as enforcement becomes less certain. Some US courts, like the Supreme

[13] *Economics of Franchise Contracts*, *supra* note 12, at 26.

[14] U.S. courts may void a contract judged procedurally or substantively unconscionable because of a severe inequality of bargaining power between the parties. The doctrine originally arose in a case of add-on clauses in credit agreements. *See* Williams v. Walker-Thomas Furniture Co., 350 F.2d 445 (D.C. Cir. 1965). A good example of the treatment of substantive unconscionability is the excessive pricing case of Jones v. Star Credit Corp., 298 N.Y.S.2d 264 (N.Y. Spec. Term 1969).

[15] English and Commonwealth courts have never properly adopted the unconscionability doctrine and Klein's argument could not apply there. One cannot have general explanations that could only be relevant in some of several similar economies.

Judicial Court of Massachusetts in *Zapatha v. Dairy Mart*,[16] have allowed termination at will without requiring good cause and not found termination unconscionable in cases where it did not jeopardize a franchisee's initial investment.

The truth is that we need to allow for a much wider range of termination laws. There is considerable variation within American jurisdictions, members of the European Union and other countries such as Canada tend to constrain the franchisor's freedom, and it important not to have a theory of hostages that could apply in some US states only. Moreover, we need also to recognize that equity doctrines, such as a duty toward dealing in good faith, and the unconscionability doctrine, as in *Zapatha v. Diary Mart*, may also arise in some cases, even in states without franchise termination statutes.[17] Among the states with such statutes, some are more restrictive compared with others.

Franchise contracts generally allow termination with notice for good cause, which indicates that contractors tend to select a good cause requirement, rather than the equivalent of dismissal at will, as found in labor law. The contract used by rental car company Avis[18] is typical in allowing the franchisee to give six-months notice to end the contract but limiting the franchisor's rights of termination to cases of substandard operation, contractual breach by the franchisee, and the franchisee's insolvency, which all constitute good cause. [19] Termination for good cause may be sufficient to support a disciplinary hostage but it gives much less clear-cut disciplinary powers to the franchisor. It is also an elementary point of contract law that courts can always use equitable doctrines to award damages to a party suffering loss following perfectly legal termination of a contract.[20]

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[16] Klein cites *Zapatha v. Dairy Mart Inc.*, 381 Mass. 284, 408 N.E.2d 1370 (Mass. 1980). The case actually tells us that the principles of unconscionability in the Uniform Commercial Code were applicable by analogy to a franchise agreement in which the sale of goods was a minor aspect, which is still a constraint on the franchisor (*Id.* at 291). The Court accepted that the termination clause of a franchise agreement, authorizing the franchisor to terminate the agreement *without cause* on ninety-days notice, was not, in the circumstances, unconscionable (*Id.* at 292).

[17] *See* King of Prussia Power Equipment Co v. Power Curbers Inc., 158 F. Supp. 2d 463 (E.D. Pa.2001), a distribution case in which the court held that action for breach of contract and breach of implied covenant could not coexist on the same facts.

[18] Avis Sub-license Agreement, undated, Clause 9.

[19] The *Zapatha* case is an unusual one where the franchise contract allowed termination at will, and implies (as is likely with diary sales or any fast-moving consumer goods) that there would have been little or no detrimental reliance by the franchisee, or no rational franchisee would have incurred sunk costs to enter into such a contract.

[20] *See, e.g.*, Goff-Hamel v. Obstetricians & Gynecologists, P.C., 588 N.W.2d 798 (Neb. 1999) (where the plaintiff recovered damages under promissory estoppel for detrimental reliance in a terminable "at will" labor contract that the defendant offered but declined to execute).

Statutory restraints on termination at will, or alternative dispute resolution mechanisms[21] designed by the parties themselves, both of which usually require good cause, might also make hostage posting difficult. At the very least, the costs of termination would rise for the franchisor, possibly by requiring a waiting period until the current contract expires. The requirement in the United States' Uniform Commercial Code ("UCC")[22] for good faith, together with statutes like the Automobile Dealer Franchise Act,[23] the Petroleum Marketing Practices Act,[24] and the state termination laws, create such restraints. Furthermore, although there are no significant direct statutory restraints on franchisor termination rights under EU law, contract-law codes in continental European jurisdictions commonly limit termination rights to good cause.[25]

Legal constraints may weaken self-enforcing mechanisms like disciplinary hostages. Franchising is used less frequently in U.S. states requiring good cause for the termination of franchisee contracts,[26] and this observation suggests that legal practice may make disciplinary hostages impractical in many franchising businesses. This conclusion directs attention to the other roles that hostages may play in supporting contract stability—notably, giving trading partners a screening device to filter out the unreliable contractor.

V. HOSTAGES IN RELATION TO ECONOMIC RENT

It is largely a rhetorical issue whether we regard sunk cost as a useful measure of hostage posting. Ex-ante, expected quasi-rents include an amount covering any expected sunk costs, and must exceed sunk costs to give at least a normal return if the specific investment is to be induced. Sunk costs may be regarded as important in the sense that ownership of the specific investment defines the ownership of a part of the ex-post rent stream, which goes to repay the original investment plus a normal return. Ex-post, it is the rents that measure the bond.

A useful comparison can be made with the expectation damages doctrine in the Anglo-American contract law. In cases of a buyer's breach, for example, the seller can claim expected profits plus any sunk costs ("detrimental reliance") incurred in anticipation of completion of the

[21] Christopher R. Drahozal & Keith N. Hylton, *The Economics of Litigation and Arbitration: An Application to Franchise Contracts*, 32 J. LEGAL STUD. 549 (2003).
[22] U.C.C. § 1-203 (1989).
[23] 15 U.S.C. §§ 1221-1225 (1982).
[24] 15 U.S.C. §§ 2801-2806 (1982).
[25] CHRISTIAN JOERGES, FRANCHISING AND THE LAW 40 (Christian Joerges ed., Baden-Baden: Nomos Verlagsgesellschaft 1991).
[26] James A. Brickley et al., *The Economic Effects of Franchise Termination Law*, 34 J.L. & ECON. 101, 101-132 (1991).

contract.[27] Simply to award lost profit would result in under compensation. Just as expectation includes profit and reliance in law, ex-post quasi-rents include normal profit, any ex-ante rents and sunk costs in contracts. In short, the premium for good behavior includes an amount equal to the anticipated return of all initial investments, provided that one owns the investment. The part of the premium that returns the investment is economic rent in the sense that any ex-post return on specific investment is a rent. Furthermore, protecting the entitlement to rent in a contract gives the law a role in supporting hostages, including a role in preventing opportunistic behavior that would render the hostage infeasible.

Therefore, it matters which party makes the initial franchise investment because doing so creates legal entitlements and property rights. Ex-post, any profit stream above avoidable costs is a quasi-rent, but steps taken ex-ante will determine how much of that rent goes to whom, and, therefore, how much each party can post as a hostage. A franchisor making the specific investment would expect a normal return, and might take some of the additional rents. The rest of the future rent stream is a legal entitlement from which the franchisee can post a hostage. If the franchisee makes the investment, ex-post, the hostage will be all of the normal profit plus any rents. In the case where the franchisee makes the sunk investment, the franchisor may be able to vary the investment requirement, contractually to create a larger hostage and deter more cheating, and, if behavior is then altered and profits increase it does indeed matter who makes the investment. It is common for franchisees to borrow against housing equity to establish their businesses. If such businesses fail, they may have a sense that there is more at stake for them compared with cases where the franchisor has paid the (sunk) initial costs. Arbitration procedures may be very important in that process of hostage design, and in governing the circumstances in which hostages may be lost.

In any long-term contract, there will be many differently valued opportunities for cheating. It really does not make sense for the parties to post the whole rent stream to cover minor infringements of the contract. This penalty would ignore the principle of marginal deterrence and would carry the risk that the promisor would be indifferent between small and large infringements of contractual conditions. Such indifference would deter contracts that would otherwise be efficient, as the promisee would worry that the steep penalty structure would cause a ratcheting up in typical promisor failures. In general, it should be worthwhile for the parties to find a governance structure that better matches penalties with damages.[28] For example, even private governance should be expected to match the structured penalties of criminal law.

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[27] E. ALLAN FARNSWORTH, CONTRACTS § 12.10 (4th ed. 2004).

[28] This still allows penalties to be raised to allow for low probabilities of deterrence.

The hostage may also sometimes need to be extended relative to the rent stream to be large enough to deter post-contract opportunism. As long as the penalty is larger than the returns from cheating for a promisor, the hostage is effective in relation to that particular type of opportunism. However, this does not mean that the hostage is successful in supporting exchange. It is still possible to attract parties with high expected values from cheating or those who expect to discover exceptional opportunities to cheat where the value exceeds the hostage. If the hostage is limited to the available ex-post quasi-rent stream, it may not be large enough. A rents-based hostage may cause a contract to attract promisors with high expected values from cheating, which may destroy the value of the contract for the promisee.[29] This may be shown with a simple example, which is again based on franchising.

Just as the problem of the excessive discrete hostage could be overcome by establishing a marginally structured series of private-enforcement penalties, the problem of too little deterrence can, too, be met by extending penalties beyond those given by the rent stream in the contract. Hostages need to be whatever is required to deter opportunism in a particular case. A way to increase the hostage is to design mechanisms into the contract that increase the value of the specific investment to the hostage posters. I call this procedure, the creation of "contractual sunkness," which may be distinguished from the technical sunkness that affects all specific investment.

Contractual sunkness cannot occur through *unnecessarily* increasing the value of the specific investment, which might be attempted by requiring a franchisee unnecessarily to trademark equipment or make "special" franchise investments (e.g., useless ornaments). The problem is that this raises costs and lowers rents; the penalty for cheating might actually be reduced. This consideration suggests that when we observe franchise-specific investments they are, in fact, genuinely needed for business purposes.

Nonetheless, much necessary investment is only made sunk by contractual means, rather than being technically determined. If franchise fittings are trademarked, they cannot be easily transferred to another use, whereas they might be easily transferred in the absence of trademarks. Similarly, if franchise investments cannot be sold to another franchisee without the consent of the franchisor, the investment is made specific by contract and not by technology. The effectiveness of this hostage depends on the franchisor's consent for sale.

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[29] A similar ("lemons") problem exists in financial markets when lenders are limited to screening borrowers using only the rate of interest. The lenders may raise rates to compensate themselves for the risk of the borrower's defaulting, but then, deter all but those with no intention of repaying the loan from applying: a severe form of adverse selection. Lenders need additional screen devices.

Contractual sunkness carries the danger that a contract-specific asset will be of direct value to the franchisor. Given the costliness of formal legal systems, contractually sunk assets are typically protected by measures safeguarding the franchisee against opportunistic seizure of the assets. The contractual protection is usually based around independent arbitration procedures and covers disagreements over costs, revenues, or the justifiability of termination. Arbitration can also be used to govern the imposition of penalties for lesser infringements of the contract where the promisee does not wish to remove the entire rent-stream premium.

The examples of contractual sunkness cited so far do not enable the hostage to be extended beyond the sum of initial investment, normal profit, and rents in the contract. There is a contractual device, however, that might well enable further extension of the hostage. This is where the franchisee is required to agree to constraints on other activities, which will potentially impose a penalty on the franchisee's income from other activities. Yet these constraints will not affect the ex-post rent stream attached to the franchise contract itself. An example of this is where a franchisor requires a franchisee to sign a covenant restricting the franchisee's operations after contractual termination. Usually, the franchisee cannot operate in the same business in the local area for a period of one to two years. This hostage is of value to the franchisee, who may already possess specialized and localized business skills. It is of no direct value for the franchisor, if we assume: (i) competitive entry into the off-brand supply into the market; and (ii) franchisor indifference over which competent franchisee runs the satellite business. Covenants do not affect the returns to the franchise contract from due performance but rather, extend the contract into other areas of the franchisee's possible activities. Similar covenants are often used in employment contracts for personal services like hairdressing, or within partnerships for professionals like lawyers and accountants. A restrictive covenant is also useful because its value may grow as the value of other hostage components fall as the contract ages. It affects the value of the alternative occupation to which human and physical capital could be moved.

VI. KEEPING CONTRACTS SIMPLE

Franchise termination laws are such a major issue that they warrant some further analysis showing that the laws achieve a purpose of enhancing simplicity in contracting. Let us examine a case where a franchisor takes a franchise to market and it is known that the franchisor might try to appropriate rents at a later date by opportunistic termination of the contract. The franchise is effectively encumbered by a risk of franchisor malpractice. The danger is that franchisees might be deterred from buying into the franchise and posting their own hostages governing their own good performance. We can examine the effects of the "encumbrance" problem by considering some principles from the economics of information.[30]

For our purposes, we assume that the franchise buyer's expectation of the reduction in the value of the i^{th} franchise outlet, owing to the existence of appropriation risk, is defined as $E_B[S_i]$, distributed over the interval $[0, S]$. The seller has precise information, so that the franchisor's expectation is $E_S[S_i] = S_i$ which is the true value. The use of expectations over the change in the value of franchises following from encumbrances is a convenient formulation in the analysis that follows. We assume franchise outlets to be standardized, apart from the risk of appropriation. The maximum value of an unencumbered franchise outlet (no appropriation risk) is S which is common knowledge. The franchisee/buyer's knowledge is influenced by search costs, C (encompassing legal research) and by institutional factors. The buyer's valuation is determined by the number of transactions in franchises (N), and jurisdictional characteristics, or qualities (A). These jurisdictional qualities include the age of the legal system, and whether it follows particular legal doctrines. A large number of transactions, particularly if relative to a small number of franchise sales, will tend to reveal appropriations over time. The known ease of enforcing contractual promises should enhance the buyer's perception of the true value of S_i, aligning the buyer's valuation with that of the seller. Therefore:

$$E_B[S_i] = f(A,C,N) \tag{1}$$

where $f'(C) \leq 0, f'(N) \geq 0, f'(A) \geq 0$ and $=f''(C) \leq 0, f''(N) \leq 0, f''(A) \leq 0$, indicating that the expected value will increase with older and more numerous transactions, and decrease with additional search costs. Change in legal doctrines, or the introduction of laws can influence perceptions and values.

The buyer always has the option of not searching, in which case the buyer assumes S_i to be uniformly distributed over the interval $[0,S]$, with $E'_B[S_i] = S/2$. The buyer searches to improve information on the i^{th} franchise transaction when:

$$dC_i < E_B[S_i] - S/2 \tag{2}$$

In other words, the search (i.e., legal research) strategy is adopted when it costs less than the value of the expected improvement in information. We assume the search strategy dominates, for all franchise sales $i = 1 \ldots n$, and the buyer's expectation over the value is given by the application of legal research in a defined legal environment.

Turning now to interactions in the market for franchises, let us assume that buyers and sellers agree on the valuation of an appropriation-

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[30] *See* Antony W. Dnes & D. Lueck, *Asymmetric Information and the Structure of Servitude Law* (2009) 38 J. LEGAL STUD. 89 (2009).

risk free franchise as $V_i = V$, $i=1 \ldots n$. The buyer's valuation of an appropriation-risk encumbered franchise is therefore, $(1-E_B[S_i])\,V$, which is offered at a price, *P*. The franchisor/seller's valuation is $(1-S_i)\,V$. The seller will sell appropriation-risk encumbered franchise outlets for $P - (1-S_i)\,V > 0$, which indicates accepting the buyer's offer, if $S_i > E_B[S_i]$. Some encumbered franchises will not be sold, owing to the buyer's inability to assess and offer a true value, given the quality of the surrounding enforcement mechanism affecting the seller's promises, which implies adverse selection if the buyer systematically underestimates the value of franchised offerings.

Turning now to interactions in the market for franchises, assume that buyers and sellers agree on the valuation of an appropriation-risk free franchise as $V_i = V$, $i=1 \ldots n$. The buyer's valuation of an appropriation-risk encumbered franchise is therefore $(1-E_B[S_i])\,V$, which is offered at a price, *P*. The seller's valuation is $(1-S_i)\,V$. The seller will sell appropriation-risk encumbered franchise outlets for $P - (1-S_i)\,V > 0$, which indicates accepting the buyer's offer, if $S_i > E_B[S_i]$. Some encumbered franchises will not be sold, due to the buyer's inability to assess and offer a true value, given the quality of the surrounding enforcement mechanism affecting the seller's promises. This implies adverse selection if the buyer systematically underestimates the value of franchised offerings.

Franchisors may run more outlets than it is efficient for them if they cannot credibly contract to refrain from opportunistic appropriation.[31] In such cases, franchise termination laws could act as a form of 'hands tying', making it clear that a franchisor cannot appropriate outlets opportunistically. The effect of this would be to increase royalty fees for a franchisor consistent with empirical observations.[32] The effect of restricting franchisor termination rights is to rule out complicated assessments of contract terms. Thus, a simplified contract emerges that is less prone to opportunistic behavior by the franchisor because liability-rule-based court governance is replaced by a property rule.

VII. Some Empirical Observations on Private Enforcement Mechanisms Within Franchise Chains

Once franchisors have sold franchised outlets, how do they typically govern their franchisees? While termination laws may reduce the likelihood that a franchisor will act opportunistically, incentives to a franchisee may not be as strong. The observations that follow are drawn

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[31] *See* W. Bentley MacLeod, *Reputations, Relationships, and Contract Enforcement*, 45 J. Econ. Literature 595-628 (2007) (noting that the underlying problem leading to adverse selection is the moral hazard preventing credible guarantees being offered over future behavior).

[32] Brickley, *supra* note 2.

from an empirical study that I carried out of private enforcement mechanisms in franchise chains and show deterrence factors at work. The study focuses on both explicit and implicit aspects of franchise contracts and enforcement mechanisms.[33] Standardized questions were used to probe for details of explicit and implicit enforcement aspects of franchise contracts. The results, which are summarized in the table below, support the claim that a schedule of penalties is applied within the rents available on the contract. However, as also noted in the results, some penalties extend enforcement beyond rents.

Franchisors were interviewed to obtain information about the private enforcement mechanisms used in their dealings with franchisees. For each franchise chain, I interviewed an average of three franchisees to cross check the information provided by franchisors. Both franchisees and franchisors were aware that their opposite numbers were to be interviewed. Franchisors were randomly selected from trade directories and responses provided by the fifty-seven participants are reported on the table below. Franchisees were randomly selected within each franchise chain. The procedure guards are far as possible against selection bias.[34] In the table, the sample is divided into 'dealer' (e.g., franchised Ford car dealerships), 'brand' (e.g., Avis), and 'other' franchises. 'Dealers' share the characteristic that they sell the manufacturer's products. 'Brand' franchises revolve almost totally around the franchisor's brand name, whereas 'other' franchises are a miscellaneous group based on some other specialist input, e.g. supply lines for generic parts used in service operations.

All of the franchisors found that they benefited from carefully screening franchisees before taking them on. This process occurs early and typically aims to discover which applicants are most likely to operate honestly, work diligently, show business acumen, and so forth. There are no cases in which the franchisor expects simply to write a self-enforcing contract, sit back, and relax. In their responses, franchisors typically describe their screening activities, which usually involve protracted interviews and identifying the applicants for whom the company's franchise systems and standard contracts 'would work.' This could be interpreted as taking a probabilistic hold-up approach. This approach seeks to delimit the range of operations and returns for which the franchise contract should be effective.

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[33] These results were generated by semi-structured interviews with franchisors and franchisees.

[34] There is some bias (toward less representation of larger franchise chains) owing to the failure of some large franchises to belong to trade associations.

Table - Enforcement Mechanisms

	Dealers	Brand	Other	Total	%
Screening	15	27	15	57	100
Exhortation	15	27	15	57	100
Arbitration	15	27	15	57	100
Fines	3	0	3	6	11
Formal Review/Notice	6	6	6	18	32
Competition	0	3	3	6	11
Lease	6	6	3	15	26
Non-renewal	0	3	0	3	5
Encouraged Sale	3	9	0	12	21
Buy Out	6	6	3	15	26
Termination	9	15	9	33	58
Restrictive Covenant	6	24	9	39	68

The franchisors stated that they found they needed to 'exhort' franchisees to keep to the spirit of their agreements. Franchisors described the frequency of exhortation as 'occasional' in almost all cases. The intention here seemed to be the identification of minor transgressions of the franchise contract. An example of a minor transgression is a quality failure, such as a problem in honoring a sales warranty. The franchisor was usually prepared to let the implied rent gain to the franchisee go retrospectively in these cases, provided that the problem is corrected. The sanction on the franchisee is partly the nuisance value of the exhortation but the franchisors also appear to be trying to lower franchisees' expectations of succeeding in infringing the agreement. This last point is of some importance because if both parties entered contracts with the same expectations of detection efficiency, there should be no infringements. Therefore, some form of active management on this front is potentially valuable in stabilizing contracts.

The interviews also reveal comprehensive use of arbitration clauses in the contracts. The franchisors resorted to arbitration procedures to settle some disputes, usually relying on the professional association, an arbitration society, or, less commonly, a compulsory arbitration. The clear motivation for arbitration mechanisms is to avoid protracted litigation.

Fines are comparatively rare with only eleven percent of franchisors reporting use of these explicit financial sanctions. Even when used, fines appeared to be of a form where the franchisor regained some revenue that had been misreported in a relatively trivial fashion (e.g., in the case of a window-blind company). Generally, product supply—not necessarily manufactured by the franchisor—was involved. The difficulty in using fines is that a franchisee may fear that there is an incentive for the franchisor to contrive reasons to fine, which may pose recruitment problems. Franchisees confirmed that it was indeed rare for fines to be imposed to settle a dispute. When fines were used, they were limited to restitution of money rather than the imposition of punitive damages (i.e. no allowance being made for under-detection). This avoidance of punitive elements accords with contract-law principles rather than the idea of criminal sanctions. Nonetheless, while rarely used, the fine is part of a structured schedule of *increasing* penalties. This approach is similar to the criminal law approach of creating marginal deterrence.

Almost one-third of franchisors undertook a formal review of some aspect of franchised operations. This amounted to citing a contractual infringement and giving notice to correct a deficiency. The steps taken amounted to more than mere exhortation and required either imposing a limit by which time a problem needed to be corrected or assigning a temporary manager to assist with a solution. Virtually all the franchisees reserved the right to forcibly persuade in this fashion, even if they have never used it. Again, the purpose appears to lie in altering the franchisee's perception of the range of circumstances over which the contract is expected to hold. Rectification of fault avoids further penalty.

A potential penalty for the franchisor to impose is to open up stores in competition with an errant franchisee. This was in fact rather rare, as shown in the table. There were few cases where franchisees fell into dispute, decided to leave the franchise network, and continued trading. Franchisors decided to operate company stores locally, possibly motivated by the difficulty of introducing a new franchisee into such circumstances. Interviews with franchisees confirmed that competitive operation was an extreme sanction that did not coexist with a continuing franchisor-franchisee relationship.

Only just over a quarter of the sample revealed any control over the franchisee's property lease by the franchisor. Although this type of control has been understood as reinforcing hostages bound up in leasehold improvements, other reasons can be found for such leasehold links. Lease control is not important in the more recent view of hostages when compared to rents. Moreover, leasehold improvements are prime examples of sunk costs. The view submitted earlier in this paper, that a title to property gives title to portions of rents, could give a hostage role to leasehold improvements. Yet, it is difficult to prevent lease control from creating a lot of power for the franchisor, as suggested by the near universal condemnation of the practice by franchisees.

Only five percent of franchisors explicitly refused to renew a franchise contract. In the table, the various penalties are listed in order of toughness, which shows that non-renewal is viewed as a serious sanction although not as tough as termination of the contract, for example. Allowing the contract to simply end gives the franchisee time to plan and make adjustments. The more frequent use of tougher forms of ending the contract suggests that franchisors do not tolerate unsatisfactory franchisees long enough to arrive at the non-renewal phase.

Encouraged sales (21 per cent), franchisor buy-outs (26 per cent) and terminations (58 per cent) were successively tougher approaches franchisors took to removing seriously failing franchisees. Bear in mind that the percentages refer to franchisors who admit to these events occurring at least once, the underlying population is less than 10 per cent of all franchisees. The most common reasons for encouraging a sale were that the franchisee did not fit well into the franchisor's systems, or that there had been too many conflicts. Such franchisees were allowed to take time in finding a buyer who provided a net return on the franchise-specific investment. Buy-outs normally occurred when a franchisee would otherwise fail and the franchisor sought to avoid embarrassment. Termination of a contract normally resulted when a franchisee was caught defrauding the system. There was a clear correlation between severe penalties for the franchisee with greater commercial damage done to the franchisor.

A surprisingly high proportion of the franchisors had used restrictive covenants with franchisees. These restricted the franchisee's commercial activities in the location and same line of business for short periods that had been found to be acceptable to courts, typically of between six months to two years. The impact is to extend the loss of rents beyond the franchise contract. The extension is potentially useful to increase penalties for poor performance given a probability of detection that is less than one. It may also be useful to maintain the value of hostages as the contract ages and to deter cheating that might take out more than the contract rents (e.g., selling misappropriated vehicles).

VIII. CONCLUSION

Generally, a disciplinary hostage can be based on *any* value that contributes to offsetting the temptation to cheat over some aspect in the contract. This should be interpreted in terms of marginal deterrence. At the contract design stage, which is of great interest in transaction-cost economics, the hostage can use some or all of contract returns, which ex-post will have quasi-rent characteristics. The hostage may even be enhanced by the use of auxiliary devices such as restrictive covenants. It does matter, however, who incurs the sunk cost of specific investment: value is expected to be returned to the holder of property rights in the investment and incurring the sunk cost usually defines the property right. Franchise contracts give an excellent illustration of the systematic development of 'mini-hostages' that are matched to particular forms of contractual discipline.

The legal system surrounding the extra-legal enforcement of promises in franchise systems is extremely important in allowing 'hostages' to be formed. Therefore, the self-supporting nature of contracts is important but should not be overestimated. Legal and extra-legal enforcement tend to be complementary forms of governance. One example of the importance of the quality of law is the effect of limits on franchise termination—once franchisees are confident about protection from opportunistic appropriation of their investments, they are more likely to buy franchises and franchise returns improve. The restrictions are typically simplifying in character. The examples of legal and extra-legal enforcement in this paper have revealed a rich adaptation to the demands of evolving franchise systems.